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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1949.

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No. 120.

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

v.

H. R. SMITH, *Respondent.*

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**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit.**

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## BRIEF OF THE RESPONDENT IN OPPOSITION.

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### Opinions Below.

The findings of fact and opinion of The Tax Court of the United States (R. 19-25) are reported at 10 T. C. 398. The opinion of the Court of Appeals (R. 61-62) is reported at 173 F. (2d) 470.

### Jurisdiction.

The judgment of the Court of Appeals was entered March 24, 1949. Petition for a writ of certiorari was filed June 14, 1949. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

## Question Presented.

On July 11, 1941, the taxpayer and two other persons organized a partnership known as "Hyman Supply Company." The Hyman Supply Company operated as a retailer of oil field supplies in Alice, Texas. The taxpayer furnished the necessary capital to the partnership and the other partners contributed their services. The taxpayer owned a sixty-five per cent interest in the partnership. On December 31, 1942, the taxpayer sold his undivided interest in the partnership to one of the remaining partners and two other persons.

The question for decision is: Was the sale by the taxpayer of his undivided partnership interest the sale of a capital asset? The Tax Court and the Court of Appeals held that the sale was the sale of a capital asset.

Petitioner's statement of the question is misleading and contrary to fact in a very important aspect. The petition states (p. 2) that the income attributable to accounts receivable would be taxed as ordinary income if the taxpayer had continued in the partnership. There is no justification in the record for such a statement.

The fact is that the partnership books were kept on the accrual basis. Consequently, the accounts receivable shown as assets of the partnership had been taken into partnership income prior to the sale. Taxpayer's distributable portion of such accounts receivable were income to him prior to the sale. By paying the capital gain tax, the taxpayer in reality has paid tax twice on these accounts receivable.

## Statement of Facts.

The facts as set forth at pages 2-6 of the petition are correct. The taxpayer sees no need for making a counterstatement.

## Argument.

### The law is judicially and legislatively settled as decided below.

Beginning in 1935, The Tax Court and various Circuit Courts of Appeal have consistently held that the sale of an interest in a partnership is taxable as the sale of a capital asset. The first case is *Dudley T. Humphrey,* 32 B. T. A. 280. In that case, a retiring partner sold his partnership interest to the remaining partners. The Board there held that the sale of the undivided partnership interest constituted the sale of a capital asset and at pages 283-284 said:

> "Now, applying the above holdings to the present case, it would appear that what petitioner sold to his partners was an intangible consisting of his right to a share in the net value of the partnership after settlement of its affairs. He had no interest in the assets of the partnership as such; consequently, what he sold was not a portion of or an interest in the partnership securities. His interest in the partnership was separate and distinct from his coownership of the partnership assets and the length of time of his ownership of the partnership interest is not measurable by the period of time that the partnership had owned the securities on hand at the time he sold his interest. He had owned his interest more than two years and in our opinion it constituted a capital asset in his hands."

The Tax Court has repeatedly held that the sale of a partnership interest constitutes the sale of a capital asset and the gain or loss which results is taxable under the provisions of Section 117 of the Internal Revenue Code. See *Estate of Daniel Gartling,* P-H T. C. Memo. Decs. ¶ 47,213, affirmed (CCA-9, Oct. 21, 1948), (170 F. (2d) 73); *L. F. Long,* T. C. Memo. (3/29/47), P-H T. C. Memo. Decs. ¶ 47,155, affirmed (CCA-5) 173 F. (2d) 471, pending before this Court on petition for a writ of certiorari, No. 121; cf. *John Whitney,* T. C. Memo. (9/12/45) P-H T. C. Memo.

Decs. ¶ 45,285; *Estate of W. T. Jones*, T. C. Memo. (2/5/44) P-H T. C. Memo. Decs. ¶ 44,028; *Frank B. Killian*, T. C. Memo. (4/27/44) P-H T. C. Memo. Decs. ¶ 44,244 (In this case the Commissioner conceded that a partnership interest was a capital asset.); *Ad. Auriema, Inc.*, T. C. Memo. (9/17/43) P-H T. C. Memo. Decs. ¶ 43,422; *H. V. B. Smith*, 5 T. C. 323; *John G. Ogden*, (6/30/49) 12 T. C. No. 158.

The various United States Circuit Courts of Appeal have likewise held that the sale of an undivided partnership interest constitutes the sale of a capital asset. This was the holding in the case of *Morris Shapiro*, B. T. A. Memorandum Opinion 1/20/40, affirmed (CCA-6) 125 F. (2d) 532, 28 A. F. T. R. 1079 (1942). In that case the Sixth Circuit, in affirming the decision of the Board said (page 1082):

> "It is fundamental in applying tax statutes that matters of substance are of first importance. The price paid for the property in question may have been based partly on assets excluded under the act from the phrase 'capital assets' such as inventories or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business, but the sale made by respondent was not a sale of those assets. It is a well settled rule of law that the joint effects of a partnership belong to the firm and not the partners and that a partner has no individual property in any specific assets of the firm, instead the interest of each partner in the partnership property is his share in the surplus, after the partnership debts are paid and after the partnership accounts are settled. *Blodgett* v. *Silberman*, 277 U. S. 1, 10, 48 S. Ct. 410, 72 L. Ed. 749. Respondent sold all of his interest in the partnership, tangible and intangible, as a going concern, which in all essentials is different from the ordinary assets of the partnership used in the usual course of its business. * * *"

See, also, *Munson* v. *Commissioner* (CCA-2), 100 F. (2d) 363, 22 A. F. T. R. 97; *Hill* v. *Commissioner* (CCA-1), 38 F. (2d) 165, 8 A. F. T. R. 10152; *McClellan* v. *Commissioner* (CCA-2), 117 F. (2d) 988, 26 A. F. T. R. 487; *Thornley* v.

*Commissioner* (CCA-3), 147 F. (2d) 416, 33 A. F. T. R. 684; *Kessler* v. *United States* (CCA-3), 124 F. (2d) 152, 28 A. F. T. R. 620. In *United States* v. *Landreth*, 164 F. (2d) 340, the Fifth Circuit held that the sale by a taxpayer of his interest in a joint adventure constituted the sale of a capital asset. It was there said:

> "The Court held that these taxpayers did not merely assign future income but parted with title to the corpus of the estate from which income was expected to be produced. We agree that the transaction involved was a joint adventure and that the sale of the taxpayer's rights was the sale of capital assets. * * *"

The gist of the petitioner's argument is that the decisions of the various courts on this question have been wrong since 1935, when The Tax Court decided the *Humphrey* case. The petitioner argues that it was the Congressional intent to tax partners as though they personally owned the assets of the partnership. Yet, the courts have been deciding otherwise since 1935.

It is established that if statutory provisions have a judicially settled meaning it is presumed that Congress legislated in the light of such meaning. *United States* v. *Merriam*, 263 U. S. 179, 187, 4 A. F. T. R. 3673; *The "Abbotsford"*, 98 U. S. 440, 444; *Kepner* v. *United States*, 195 U. S. 100, 124.

It would appear that if the Commissioner is dissatisfied with the decision below that he should ask Congress to remedy the situation rather than ask this Court to engage in judicial legislation. This is particularly true because Congress has repeatedly re-enacted revenue laws in the light of the judicial interpretation followed in the case at bar and which is assailed by the Commissioner.

It should also be remembered that as recently as May 17, 1948 (334 U. S. 819) this Court denied certiorari in *Commissioner of Internal Revenue* v. *Lehman*. The petition in the *Lehman* case stated the first question to be the identical

question here involved. As the petition in the case at bar (p. 17) indicates, the Commissioner is as dissatisfied with the action of this Court in denying certiorari in the *Lehman* case as he is with the established law on the subject. Since this Court's denial of certiorari in the *Lehman* case, there have been no developments which in any way change the situation.

It may also be observed that the rule the taxpayer contends for, and which is as decided below, results in ease of administration. If such sales are treated as sales of capital assets, the computation of the tax will be simple. However, if each asset must be considered and its status determined, a tremendous accounting and administrative problem will result.

**Petition is Based on Statements Which Are Contrary to the Actual Facts and Are Not Supported by the Record.**

The petition states (p. 7):

> "* * * In the present case, a large portion of the partnership assets consisted of accounts receivable, the income from which, as collected, would have been taxable as ordinary income to the taxpayer and to his partners. Yet the decision below permits the taxpayer, who transferred his interest in these receivables to the members of the new firm, to treat the gain attributable to these receivables as though it were capital gain. * * *"

The foregoing statement is not true and is not supported by the record.

The fact is that the partnership books were kept on the accrual basis. Consequently, the accounts receivable shown as assets of the partnership had been taken into partnership income prior to the sale. Taxpayer's distributable portion of such accounts receivable was income to him prior to the sale. By paying the capital gains tax, the taxpayer in reality has paid tax twice on these accounts re-

ceivable. He is not avoiding tax as the Commissioner implies.

There is nothing in the record to show that the accounts were not kept on an accrual basis. The record does show reserves and accrued items which are customarily used in accrual bookkeeping. (R. 20, 21, 22, 30, 31)

Admittedly, the partnership used an inventory (Pet. 4, 7, R. 20). Treasury regulations have always provided that books must be kept in a manner as to clearly reflect income. Likewise, they have provided that if it is necessary to use an inventory, the accrual method of keeping books must be used. ¶ 6068 P-H Fed. Tax Service. The present regulations provide:

> "* * * in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method."

In view of the regulation just quoted, it is obvious that the Commissioner would not have accepted the partnership returns had they not been based upon accrual accounting.

The Commissioner also argues that depreciable property could not be converted into capital gain by the partnership. Such is not the case. Section 117(j), Internal Revenue Code, specifically includes within the capital gains provisions gains or losses from the sale or exchange of property used in the trade or business which is held for more than six months and which is of a character subject to the allowance for depreciation. This section is set out in full at page 9 hereof as the Commissioner's quotation from Section 117 does not include sub-section (j).

Because of the foregoing, it would appear that much of the Commissioner's argument is based on statements which are not true and which are not supported by the record.

## Conclusion.

In this case, the petition should be denied for the following reasons:

(1) The decisions below are based upon firmly established judicial and legislative interpretation.

(2) The petition is based to a large extent upon statements which are not true and which are not supported by the record.

Respectfully submitted,

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July 13, 1949.

## APPENDIX.

INTERNAL REVENUE CODE:

"Sec. 117(j). Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

"(1) Definition of property used in the trade or business.—For the purposes of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k)(1) or (2) is applicable.

"(2) General rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

"(A) In determining under this paragraph whether gains exceed losses, the gains and losses described

therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

"(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion."